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No. 83-65

# In the Supreme Court of the United States

OCTOBER TERM, 1983

LEASEWAY TRANSPORTATION CORP., ET AL.,
PETITIONERS

*v.*

UNITED STATES OF AMERICA, ET AL.

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

## BRIEF FOR THE RESPONDENTS IN OPPOSITION

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## QUESTIONS PRESENTED

1. Whether internal audit reports, prepared by a corporation's employees in the ordinary course of business, "may be relevant" within the meaning of 26 U.S.C. 7602(1) to an Internal Revenue Service audit of the corporation and therefore are subject to production pursuant to an IRS summons.

2. Whether a corporation's internal audit reports are privileged from production pursuant to an IRS summons issued under 26 U.S.C. 7602.

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## BRIEF FOR THE RESPONDENTS IN OPPOSITION

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### OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A12) is unreported. The opinion of the district court (Pet. App. B1-B21) is reported at 523 F. Supp. 1333.

### JURISDICTION

The judgment of the court of appeals was entered on April 19, 1983. A petition for rehearing was denied on June 7, 1983 (Pet. App. C1). The petition for a writ of certiorari was filed on July 15, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

### STATEMENT

1. In July 1979, the Internal Revenue Service began a tax audit of petitioner Leaseway's corporate income tax returns for the years 1975 through 1978. Petitioner Rehor was then Leaseway's vice president in charge of tax matters. Internal

Revenue Agent Simeo was the case manager for the audit. Pet. App. B2, B4; A. 5-8, 20-23, 33-34, 38, 49, 50, 55, 81, 279, 280, 283, 291.[1]

IRS procedural manuals provide that in conducting audits such as this one, revenue agents are to examine internal audit reports ("IARs") of the taxpayer. In addition, Internal Revenue Agent Kast, the case manager for the prior audit of Leaseway, had recommended in his post-audit memorandum that Leaseway's IARs be examined in the next audit. In planning the 1975-1978 tax audit, Simeo decided to examine Leaseway's internal audit reports because of the provisions of the procedural manuals and Kast's recommendation. Pet. App. B3; A. 11-15, 28, 43, 187, 190-193, 200, 203, 255, 280.

On April 8, 1980, Rehor was served with an Internal Revenue summons requiring production of 82 audit reports pertaining to certain subsidiaries of Leaseway for various years during the audit period. On April 21, 1980, Rehor informed the audit team that Leaseway would not comply with the summons. Pet. App. B7; A. 20-27, 42, 90-94, 122-123, 129-130, 222-223, 263-264, 272-273, 282, 285-288, 291-292.

On July 1, 1980, the government initiated this action to enforce the summons in the United States District Court for the Northern District of Ohio. In his affidavit in support of the petition for enforcement, Simeo averred that the summoned reports were not in the government's possession, that the administrative steps required for issuance of the summons had been taken, and that it was necessary to examine the reports in order to complete the audit properly.

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[1] "A." refers to the appendix filed in the court of appeals.

Leaseway opposed enforcement on the ground that examination of the reports would provide no significant assistance in determining its correct tax liabilities. A. 91-94, 122-123, 263-264, 272-273, 285-288, 291-292.

In a show cause hearing conducted by the district court, Simeo stated that the IRS had not seen Leaseway's IARs and had no specific information as to their contents. Kast testified that, based on the experience of the IRS, a taxpayer's internal audit reports can provide information that is of assistance in conducting an audit and can increase the efficiency of an IRS audit by indicating particular matters that do or do not need to be investigated closely. Rehor explained that Leaseway's IARs had not been used in the preparation of its tax returns. In addition, Walter G. Kell, an accounting professor, appeared on behalf of Leaseway. He testified that he had inspected the summoned IARs at Leaseway's request and concluded that there was only a remote possibility that information in the reports would be helpful in assessing the accuracy of Leaseway's tax returns. Kell noted, however, that one of the reports concerned the plant and equipment account; that another report recommended improvements in maintaining records on accounts receivable; and that the IARs included recommendations for correcting entries in Leaseway's accounting records. Kell also acknowledged that internal audit reports can be helpful in identifying problem areas in a corporation's accounting system that would call for closer examination. Pet. App. B12; A. 30, 45-46, 88, 89, 136-137, 142, 149-154, 161-172, 175-176, 197, 199, 201, 288-289.

2. The district court enforced the summons (Pet. App. B1-B21). The court found that the Internal Revenue Code afforded broad authority to summon records bearing on a taxpayer's finances and that the "concrete facts in this case" demonstrated the relevance of the reports sought by the IRS. In particular, the court noted the Kell testimony "that

the reports contained 'reference to individual transactions' " and also "contained 'one or two correcting entries relative to an incorrect reversal of an entry or incorrect recording of an entry' * * * [that] 'could conceivably have an impact on the financial statement' from which the tax return was prepared" (*id.* at B18). The court also referred to the Kell testimony that the reports "contained 'timing adjustments' * * * that * * * could have an effect on the accuracy of a particular tax return" (*id.* at B19). Finally, the court observed that the recommendation in the reports that more detailed records be maintained to substantiate ledger entries, as summarized in the Kell testimony, was relevant because the sufficiency of the records could bear on the correctness of the tax return (*ibid.*). Based on this record, the court concluded that the internal audit reports summoned by the IRS were relevant and subject to production because they "may, in fact, shed light on the correctness of the Leaseway tax returns" (*id.* at B20).

3. The court of appeals affirmed (Pet. App. A1-A12). Stating that the "standard of relevance is whether the information sought 'might throw light upon' the inquiry" (*id.* at A7; citation omitted) and that the "showing [of relevance] must be one of a realistic expectation, rather than an idle hope, that something pertinent to the investigation may be discovered" (*id.* at A7-A8), the court of appeals agreed with the determination of the district court that "there exists a realistic expectation that something discovered in the IARs might throw light upon this investigation into the accuracy of Leaseway's tax returns" (*id.* at A8). In addition, the court of appeals rejected Leaseway's contention that the reports were privileged from production under *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, No. 82-687 (Feb. 22, 1983). The court found it unnecessary to "pass upon the correctness of" the *Arthur Young* holding because the two cases are

"factually distinguishable" in light of the nature of the papers involved and the fact that this case — unlike *Arthur Young* — does not involve questions as to the role of independent auditors under the federal securities laws (Pet. App. A10-A11). The court also pointed out that the Second Circuit had indicated that it would enforce an IRS summons for audit reports notwithstanding that *Arthur Young* fashioned a privilege for tax accrual workpapers (Pet. App. A10-A11), and thus "even in a jurisdiction which recognizes a judicially created accountant's work-product privilege, *internal audit reports* were not considered privileged documents" (*id.* at A12; emphasis in original).

## ARGUMENT

1. Petitioners contend (Pet. 17-20, 25-30) that the standard of relevance applied by the court of appeals was erroneous. However, the decision below is correct and does not conflict with any decision of this Court or of the other courts of appeals. Accordingly, further review is not warranted.[2]

Section 7602(1) and (2) of the Internal Revenue Code (26 U.S.C.) provides that the IRS is authorized to summon and examine "any books, papers, records, or other data *which may be relevant* or material to [its] inquiry" (emphasis added). See also *United States* v. *Powell*, 379 U.S. 48, 57 (1964). As Judge Friendly explained in *United States* v. *Noall*, 587 F.2d 123, 125 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979), "Congress acted advisedly in using the verb 'may be' rather than 'is,' since the Commissioner cannot be certain that the documents are relevant or material until he sees them."

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[2]Petitioners acknowledge (Pet. 20) that only four previous cases have dealt with the relevance of internal audit reports. Many of the cases on which petitioners rely (Pet. 18-20) did not pertain to IARs.

Consistent with the language and policy of Section 7602, the courts have recognized the broad authority of the IRS to obtain materials in connection with its audit of a taxpayer. In particular, the courts of appeals have consistently held that summoned materials are relevant if they might throw light upon the inquiry being made by the IRS. See, *e.g., United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994, 996 (10th Cir. 1982); *United States* v. *Will*, 671 F.2d 963, 966 (6th Cir. 1982); *United States* v. *Kis*, 658 F.2d 526 (7th Cir. 1981), cert. denied *sub nom. Salkin* v. *United States*, 455 U.S. 1018 (1982); *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981); *United States* v. *Richards*, 631 F.2d 341, 345 (4th Cir. 1980); *United States* v. *Freedom Church*, 613 F.2d 316, 321 (1st Cir. 1979); *United States* v. *Garden State National Bank*, 607 F.2d 61, 68-70 (3d Cir. 1979); *United States* v. *Noall*, 587 F.2d at 125-126; *United States* v. *Ryan*, 455 F.2d 728, 733 (9th Cir. 1971). The court below correctly recognized this to be the applicable standard (Pet. App. A7).

To be sure, as petitioners note (Pet. 18), some courts have added that there must be a realistic expectation, and not simply an idle hope, that the summoned information will assist in determining the taxpayer's correct tax liabilities. See, *e.g., United States* v. *City National Bank & Trust Co.*, 642 F.2d 388, 389-390 (10th Cir. 1981); *United States* v. *Wyatt*, 637 F.2d at 301; *United States* v. *Matras*, 487 F.2d 1271, 1274 (8th Cir. 1973); *United States* v. *Egenberg*, 443 F.2d 512, 515 (3d Cir. 1971); *United States* v. *Harrington*, 388 F.2d 520, 524 (2d Cir. 1968). We doubt that this addition represents a substantive variation in the standard of relevance, but instead is a common-sense explication of an implicit element of the relevancy test. And, as shown by the above cases, the "might throw light upon" and the "realistic expectation" formulations, rather than being inconsistent

tests as petitioners contend, are routinely applied together and treated as a single standard.[3]

In any event, this is not an appropriate case in which to consider petitioners' assertion that the two formulations constitute conflicting standards of relevance. The court of appeals, after referring to the "might throw light upon" formulation (Pet. App. A7), immediately added that the requisite "showing must be one of a realistic expectation, rather than an idle hope, that something pertinent to the investigation may be discovered" (*id.* at A7-A8).[4] Thus, the

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[3]There is no conflict, as petitioners assert (Pet. 18-20), between *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111 (N.D.Ill. Oct. 23, 1978), and *United States* v. *Noall*, 587 F.2d 123 (2d Cir. 1978), cert. denied, 441 U.S. 923 (1979). In *First Chicago Corp.*, the district court, relying on decisions of the Second and Seventh Circuits, held that certain internal audit reports were relevant and that others were not. The holding of the district court and the decisions cited by the court, as well as subsequent decisions of the Seventh Circuit (see, *e.g.*, *United States* v. *Kis*, 658 F.2d at 537), are fully consistent with *Noall* and with the standard of relevance applied in the other circuits. And in any event, a conflict between decisions of a district court and a court of appeals does not call for review by this Court. See Stern & Gressman, *Supreme Court Practice* § 4.8 (5th ed. 1978).

We note that the Court is holding the cross-petition filed by Arthur Young, No. 82-837 (filed Nov. 11, 1982), in response to the government's petition in No. 82-687. The Arthur Young cross-petition argues (Pet. 8, 9), in opposing production of audit workpapers, that "a request for documents based on their generic characteristics cannot establish relevancy without a further definition of the subject matter sought. * * * [A] summons which requests, for example, all correspondence without more cannot on its face be tested for relevancy and is *per se* improper." Given the differences between this case and No. 82-837 with respect to the questions presented, the documents at issue, and the specifications of the summonses, we do not believe that the pendency of the Arthur Young cross-petition requires that the Court also hold the instant petition.

[4]Indeed, the court of appeals cited (Pet. App. A8) many of the same cases that petitioners rely upon (Pet. 18) in their challenge to the decision below.

court of appeals in fact applied the "reasonable expectation" standard that petitioners urge, and any differences that might exist between the two formulations would not affect the outcome in this case.

Moreover, as both the district court and the court of appeals concluded, the record in this case demonstrates the relevance of the summoned reports. Agent Simeo, in his affidavit submitted in support of the petition for enforcement, stated that the proper conduct of the investigation required examination of Leaseway's IARs. In addition, the government presented testimony that IRS manuals provide for examination of IARs, that past experience indicates that IARs can further investigations, and that the IRS agent conducting the prior audit of Leaseway's returns had recommended examination of the IARs in the next audit. Cf. *United States* v. *Noall*, 587 F.2d at 126; *United States* v. *I.C. Industries, Inc.*, 83-1 U.S. Tax Cas. (CCH) para. 9149 (N.D. Ill. Jan. 12, 1983). The government thus established a prima facie case that the reports were relevant to the tax investigation.[5]

The Kell testimony offered by Leaseway to rebut the government's prima facie case further established the relevance of the IARs, as the district court specifically found (Pet. App. B18-B19). Kell stated that one of the reports involved Leaseway's account for plant and equipment, which is a matter of concern to the IRS in evaluating depreciation deductions. Kell also testified that another report indicated weaknesses in the recordkeeping for accounts receivable, which can bear on the reportable income and bad debts of the taxpayer. In addition, Kell

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[5]Petitioners acknowledge (Pet. 6 n.4; citation omitted) that internal audit reports can " 'test reporting systems in * * * financial [areas],' " and they conceded in the court of appeals (Reply Brief 3) that Leaseway's IARs involve "financial as distinguished from operational matters."

noted that other reports recommended that corrective entries be made in accounting records, which raises questions about the correctness of Leaseway's tax returns as prepared from its accounting records. And, finally, Kell acknowledged that auditors, including the IRS, can find examination of IARs to be helpful and can indicate problem areas in a company's accounting records that should be closely examined. Thus, although Kell was of the opinion that there was only a remote possibility that the IARs would be of assistance to the IRS in determining Leaseway's tax liabilities, the district court did not err in relying on other portions of his testimony in concluding that the summoned reports were not outside the bounds of relevance.[6]

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[6]We also note that in the case most heavily relied upon by petitioners (Pet. 18-19), the district court found that various internal audit reports of the taxpayer were relevant and subject to production. See *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111 (N.D.Ill. Oct. 23, 1978). See also *United States* v. *Noall*, 587 F.2d at 126, which was quoted by the court of appeals below (Pet. App. A6-A7).

Petitioners complain (Pet. 25-27, 29) that the IRS did not know what was in the IARs and therefore had no reasonable expectation of relevance. But this largely reflected the fact that Leaseway had declined to provide either the reports or a description of their contents. That the IRS had no specific information about the substance of these particular documents does not bar it from gaining access as part of an audit, and, as discussed above, the government made an adequate showing of relevance in this case. Nor, contrary to petitioners' suggestion (Pet. 27, 29), is the IRS or a district court required to take the taxpayer's word that designated materials are not relevant. While a district court may conduct an *in camera* examination of summoned documents (see *United States* v. *First Chicago Corp., supra*), it is not, as petitioners contend (Pet. 23), required to follow such a burdensome and time-consuming procedure. See *United States* v. *Noall*, 587 F.2d at 127.

The fact that the internal audit reports may not have been used in preparing Leaseway's tax returns does not render them irrelevant to the IRS's audit. Materials not used in a tax return unquestionably "may be relevant * * * [to the Commissioner's] inquiry" under Section 7602(1), and courts have enforced summonses for such materials. See, *e.g.*, *United States* v. *Euge*, 444 U.S. 707 (1980) (exemplar of the taxpayer's

2. Petitioners also argue (Pet. 8-16, 28-30) that the internal audit reports are privileged from production to the IRS under the rationale of *United States* v. *Arthur Young & Co.*, 677 F.2d 211 (2d Cir. 1982), cert. granted, No. 82-687 (Feb. 22, 1983). They contend that these reports serve the

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handwriting); *Donaldson* v. *United States*, 400 U.S. 517 (1971) (employment applications and background data); *United States* v. *New York Telephone Co.*, 644 F.2d 953 (2d Cir. 1981) (telephone company billing records); *United States* v. *Wyatt*, 637 F.2d 293, 300 (5th Cir. 1981) (evidence relating to illegal payments whether or not deducted on the returns); *United States* v. *Noall*, 587 F.2d at 125 (internal audit data not used in preparation of returns); *United States* v. *Cleveland Trust Co.*, 474 F.2d 1234 (6th Cir.), cert. denied, 414 U.S. 866 (1973) (net worth statements submitted to bank with loan application); *United States* v. *McKay*, 372 F.2d 174 (5th Cir. 1967) (appraisal reports); *United States* v. *Khalouf*, 49 A.F.T.R. 2d para. 82425 (N.D. Ind. Dec. 9, 1981) (video tapes); see also *United States* v. *Southwestern Bank & Trust Co.*, 693 F.2d 994 (10th Cir. 1982); *United States* v. *Norcutt*, 680 F.2d 54 (8th Cir. 1982); *United States* v. *Noall*, 587 F.2d at 127; *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86035-86036.

Finally, enforcement is not barred, as amicus Pickands Mather & Co. argues (Br. 7-8), on the ground that the information contained in the internal audit reports may be found in or derived from other documents available to the IRS. Documents are not immune from production simply because they collect, summarize, or analyze information that may be uncovered in a less convenient or intelligible form elsewhere. As the court of appeals explained (Pet. App. A9):

> The IRS need not duplicate the efforts of Leaseway. To hold otherwise would be to invite taxpayers to surrender to the IRS only the minimum amount of underlying documentation available and to require the IRS to then compile the data into us[e]able form, even though such compilations already exist. Such a limited discovery rule would retard the policy interest of effective tax law enforcement and revenue collection.

See also *United States* v. *Silvestain*, 668 F.2d 1161, 1163 (10th Cir. 1982); *United States* v. *Daffin*, 653 F.2d 121, 124 (4th Cir. 1981); *United States* v. *Davis*, 636 F.2d 1028, 1037-1038 (5th Cir.), cert. denied, 454 U.S. 862 (1981); *United States* v. *Davey*, 543 F.2d 996, 1000 (2d Cir. 1976). *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86035-86036. As the Second Circuit has observed, petitioners' argument "borders on the frivolous" (*United States* v. *Noall*, 587 F.2d at 125 n.2).

important purposes of encouraging compliance with legal requirements and enhancing corporate efficiency and that the use of such reports would be deterred if they were subject to compelled production to the IRS. On this basis petitioners claim that the reports should be protected by a qualified accountant's privilege.

As demonstrated in our brief in *Arthur Young*,[7] the creation of an accountant's privilege is not warranted. This Court and the lower federal courts have, with the exception of *Arthur Young*, consistently held that there is no federally recognized accountant's privilege (U.S. Br. 35-39). These decisions reflect the fact that only the weightiest reasons of public policy can justify a privilege, which limits the availability of probative evidence and impairs the search for truth (U.S. Br. 15). And the considerations militating against the recognition of a privilege assume special force in connection with an IRS summons. "With respect to enforcement of the tax laws, Congress itself has decided the policy issue [in favor of IRS access], and it is not for the courts to challenge that determination. In this, as in many other procedural questions, the collection of the revenue stands apart." *United States* v. *Noall*, 587 F.2d at 126, quoted in U.S. Br. 44. Thus, for the reasons set forth in our brief in *Arthur Young*, we submit that petitioners' effort to establish an accountant's privilege in this case must be rejected.

We further submit that it is unnecessary for the Court to hold this petition pending its decision in *Arthur Young*. An affirmance of the Second Circuit's ruling in *Arthur Young* would not aid petitioners in this case or indicate the need for review of their contentions by this Court.

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[7] A copy of our brief is being sent to counsel for petitioners.

Fundamental differences exist between the sorts of documents at issue in the two cases. In *Arthur Young*, the tax accrual workpapers in question apparently contain, among other things, the accountant's and the taxpayer's assessment of the strengths and weaknesses of the taxpayer's position on matters that might be contested by the IRS and an indication of the taxpayer's views concerning litigation and settlement in the event of a challenge. Moreover, tax accrual workpapers are prepared as part of the audit by independent certified public accountants that is required under the federal securities laws, and thus they involve a reasonably definite and circumscribed class of material. In contrast, IARs prepared by in-house auditors are not alleged to contain information of a similarly sensitive and deliberative nature. Furthermore, by petitioners' own description (Pet. 6 & n.4, 8-11; Pet. App. D2), internal audit reports are voluntarily prepared by companies on a virtually unlimited range of subjects, including "compliance with company policy" (Pet. 6) and " 'how efficiently and economically management utilizes its resources and how effectively it achieves its objectives' " (Pet. 11; citation omitted). Under such a broad and self-defining rubric, a taxpayer would be free to label a host of documents as "internal audit reports," and the consequent restriction on IRS access and the potential for abuse by taxpayers strongly counsel against recognition of such a privilege. See *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86036.

Further, the essential basis for the *Arthur Young* decision is absent here. In *Arthur Young*, the court of appeals concluded that the federal securities laws, pursuant to which the tax accrual workpapers had been generated, represented a " 'contrary legislative purpose[]' " (677 F.2d at 219; citation omitted) that "conflict[ed]" (*ibid.*) with the policies of the Internal Revenue Code. In reconciling this perceived

"clash" (*id.* at 220) of congressional enactments and statutory policies, the court of appeals chose to give priority to the purposes of the securities law by creating a qualified privilege for tax accrual workpapers. By contrast, petitioners have pointed to no conflicting statute or countervailing legislative policy that would, in accordance with the analysis in *Arthur Young*, support the privilege they seek to establish.[8]

In line with these critical distinctions between this case and *Arthur Young*, the Second Circuit itself has rejected the very privilege that petitioners claim. In *United States* v. *Noall, supra*, which was reaffirmed in *Arthur Young*, the court of appeals held that "public policy" in favor of "full and frank disclosure to the internal auditors" does not render internal audit reports privileged from production in response to an IRS subpoena (587 F.2d at 126). See also *United States* v. *First Chicago Corp.*, 79-1 U.S. Tax Cas. (CCH) para. 9111, at 86036 ("particular policy considerations" in favor of "total candor" do not give rise to a privilege for internal audit reports). Furthermore, in *Arthur Young*, the court enforced an IRS summons for audit workpapers (677 F.2d at 216) even though such "workpapers contain material learned during confidential discussions between [the taxpayer] and [the accountant]" (*id.* at 215). Thus, as the court below correctly noted (Pet. App. A12; emphasis in original), even in the Second Circuit, "which recognizes a judicially created accountant's work-product privilege, *internal audit reports* [are] not considered privileged documents."

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[8]Nor would the limited societal interest served by any resulting "enhancement of corporate efficiency" (Pet. 10) or encouragement of inquiry by auditors into a corporation's compliance with the law (Pet. 8) warrant judicial creation of an accountant's privilege from congressionally authorized investigations with respect to internal audit reports. Compare *Hickman* v. *Taylor*, 329 U.S. 495, 510-511 (1947); *United States* v. *Nobles*, 422 U.S. 225, 236-237 (1975); *Upjohn* v. *United States*, 449 U.S. 383, 389 (1981).

In the end, petitioners have failed to justify why internal audit reports — in contrast to countless other corporate documents that touch upon legal and operational issues and are unquestionably subject to compulsory production — should be privileged from an IRS summons in connection with an audit of the corporation. Petitioners understandably would prefer to withhold these reports from the IRS, but they have not offered the "weighty and legitimate competing interests" (*United States* v. *Nixon*, 418 U.S. 683, 709 (1974)) necessary to offset the manifest public need for the efficient and effective enforcement of the Internal Revenue Code. Since petitioners' claim of privilege would not be assisted by an affirmance of the Second Circuit's decision in *Arthur Young*, it is unnecessary for the Court to hold this petition pending disposition of the *Arthur Young* case.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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